SUPERIOR COURT, STATE OF WASHINGTON, COUNTY OF SPOKANE

MIKE KREIDLER, THE INSURANCE COMMISSIONER OF THE STATE OF WASHINGTON, AS RECEIVER FOR WESTERN UNITED LIFE ASSURANCE COMPANY, Plaintiff, vs. ERNST & YOUNG LLP, Defendant.	No. COMPLAINT FOR PROFESSIONAL NEGLIGENCE, NEGLIGENT MISREPRESENTATION AND BREACH OF CONTRACT

Plaintiff MIKE KREIDLER, the Insurance Commissioner of the State of Washington, in his capacity as Receiver (hereinafter referred to as "Plaintiff" or Receiver") for WESTERN UNITED LIFE ASSURANCE COMPANY (hereinafter "Western United"), alleges the following:

INTRODUCTION

1. This is a civil action brought by the Receiver pursuant to Sections 48.99.020(2) and 48.31.040(1,4) of the Revised Code of Washington ("RCW"), and by authority granted the

Insurance Commissioner by the Order of Rehabilitation and Appointment of Receiver issued by the Thurston County Superior Court.[1] Plaintiff seeks damages for losses proximately caused by the negligence, negligent misrepresentations, and other conduct of Defendant Ernst and Young LLP (herein after referred to as "Ernst & Young"). Such damages include, but are not limited to, an award of lost revenues, profits and property, compensation for lost business opportunities and asset dissipation, and the indemnification of all sums incurred and expended in connection with the rehabilitation of Western United, plus costs of suit and attorneys fees, and all other or further relief allowed by law.

2. As the independent auditor for Western United and Western United's direct and indirect parents and certain other affiliated companies, as hereinafter identified, Ernst & Young issued unqualified audit opinions for fiscal years 2001 and 2002, representing that the companies' financial statements for those years conformed with applicable accounting principles and fairly and accurately reflected the companies' financial condition.

3. Ernst & Young was aware or should have been aware that the Office of the Insurance Commissioner of the State of Washington ("OIC") relied on these audited financial statements for, among other things, determining Western United's compliance with the financial requirements for conducting insurance business under Washington law.

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[1] The Thurston County Superior Court appointed the Insurance Commissioner as Statutory Receiver, James Odiorne as Receiver, and Wayne Metcalf as Chief Deputy Receiver. They are referred to in the Order collectively as "the Receiver." Pursuant to RCW 48.99.030(6), Mr. Odiorne and Mr. Metcalf may act for the Commissioner.

4. The audits conducted by Ernst & Young were not performed in accordance with industry standards or the duties that Ernst & Young owed Western United and the OIC. Among other failings, the Ernst & Young audits failed to disclose significant and material accounting abuses and internal control deficiencies at Western United and among its direct and indirect parent and affiliate companies.

5. In January 2004, Ernst & Young unilaterally resigned as auditor. Shortly thereafter, Western United's indirect parent company, Metropolitan Mortgage & Securities Co., Inc. ("Metropolitan") and its affiliate, Summit Securities, Inc. ("Summit") filed voluntary petitions under chapter 11 of the Bankruptcy Code and Western United was placed into receivership for the purposes of rehabilitation.

6. In the Metropolitan and Summit bankruptcy cases, the Bankruptcy Court appointed an independent examiner (the "Examiner") to conduct an investigation and report his findings to the Bankruptcy Court. On June 8, 2004, the Examiner concluded an evaluation of, among other things, Ernst & Young's performance as auditor for Western United and its certain affiliated companies, including Metropolitan and Summit. In his report, the Examiner concluded: "Metropolitan Group's independent auditors [Ernst & Young for the years 2001 and 2002] were likely negligent in the performance of their duties and may have liability both to the Debtors, their nonfiling affiliates (including the Insurance Companies) and to third parties who relied upon the audited financials. The Examiner believes this is especially true with respect to the recognition of gain on intercompany transactions, as the Examiner has found that the Metropolitan Group was essentially operated and controlled by a small core group of

management (itself dominated and controlled by [Paul] Sandifur and that none of the members of the Metropolitan Group (including the Insurance Companies) were operated as independent entities." (Examiner's June 8, 2004 Report at p. 13).

7. The Examiner concluded that Ernst & Young was confronted with "overwhelming evidence" showing that "an audit client had few, if any, effective internal controls, had a chaotic and antiquated accounting system, was rapidly expanding into a high risk commercial lending niche without any obvious background and experience, and had underwriting and lending practices that . . . were at best disorganized and at worst reckless." (Examiner's June 8, 2004 Report at p. 206)

8. Ernst & Young repeatedly ignored or negligently failed to discover these material and significant deficiencies in internal controls and accounting and management practices. Despite a multitude of red flags highlighting serious problems at Metropolitan and its affiliated companies and subsidiaries, Ernst & Young failed to disclose or report any material weaknesses or reportable conditions existing at Western United or its direct or indirect parents or any of its affiliated companies. Moreover, Western United's financial statements, which were audited by Ernst & Young and filed with and relied upon by the OIC, never identified any such deficiency.

9. Ernst & Young's failure to report these deficiencies in internal controls and management and accounting practices was a violation of applicable accounting and auditing standards, the professional standard of care required of Ernst & Young, and the duties Ernst & Young owed to Western United and the OIC. As a direct and proximate result of Ernst & Young's failure to disclose these widespread deficiencies and Ernst & Young's

misrepresentations regarding the accuracy of Western United's financial statements and the quality of its own audit procedures, Western United has suffered, and continues to suffer, substantial damages.

JURISDICTION AND VENUE

10. This Court has subject matter jurisdiction over this action pursuant to Article IV, Section 6, of the Constitution of the State of Washington.

11. Venue properly lies in this Court under RCW ch. 4.12 because the acts and transactions giving rise to Plaintiffs' claims occurred in Spokane County, Western United was principally located in Spokane County during the relevant period of this Complaint, and the Defendant transacted business in Spokane County.

PARTIES

A. Plaintiff

12. Western United is a Washington insurance company that maintains its principal place of business in Spokane County, Washington. Incorporated in 1963, Western United primarily sells intermediate-term annuity products and, to a lesser extent, long-term annuities. Western United is regulated as a Washington domiciled insurer by the OIC.

13. On December 24, 2003, Western United consented to an order for supervision with the OIC. On March 2, 2004, following the formal request of the OIC, the Insurance Commissioner was appointed as Receiver for Western United. See Exhibit 1 Order of Rehabilitation and Appointment of Receiver (Mar. 2, 2004) issued in Mike Kreidler v.

Western United Life Assurance Company, No. 04-2-00406-1, Thurston County Superior Court (hereinafter the "Receivership Order").

14. To rehabilitate Western United, the Receivership Order granted the Insurance Commissioner the power pursuant to RCW 48.31.040 to:

> [T]ake possession of all the assets, books, records, files and all of the property, real and personal, contracts, and rights of action of Western United located in the State of Washington or elsewhere, and . . . [to] deal with the property and business of Western United in his own name or in the name of Western United in receivership. The Receiver shall conduct the business of Western United, and shall take such steps as the Court may approve, and the Receiver shall administer the assets of Western United under the general supervision of the Court.

Receivership Order at 2, ¶ 2.

15. Plaintiff's court-ordered powers are consistent with and supplement those otherwise provided to the Receiver under RCW 48.99.020(2):

> As domiciliary receiver the commissioner shall be vested by operation of law with title to all of the property, contracts, and rights of action, and all the books and records of the insurer [Western United] wherever located, as of the date of entry of the order directing him to rehabilitate or liquidate a domestic insurer . . . and he shall have the right to recover the same and reduce the same to possession . . . .

RCW 48.99.020(2).

16. The Insurance Commissioner in his capacity as Receiver thus has title to all rights of action of Western United, including but not limited to, those causes of action asserted herein. The Insurance Commissioner brings this Complaint in his capacity as Receiver for Western United.

17. The OIC has responsibility for regulating all insurance business within the State of Washington pursuant to the authority granted by the insurance laws of this State. Mike Kreidler is the Insurance Commissioner for the State of Washington.

B. Defendant

18. Defendant Ernst & Young is a Delaware limited liability partnership that maintains a place of business in the State of Washington at 999 Third Avenue, Suite 3500, Seattle, Washington. Ernst & Young is one of the world's largest professional services firms and offers a variety of services to clients, the most important of which are accounting and audit services. At all times relevant to this Complaint, Ernst & Young represented itself to the OIC and to Western United as an expert providing professionally competent accounting and audit services, and Ernst & Young acted by and through its partners and employees in the course and scope of their employment.

19. Ernst & Young audited the financial statements of Western United on a statutory accounting basis for the years ending December 31, 2001 and 2002. Ernst & Young was also engaged to review Western United's quarterly financial statements and did so during 2001, 2002, and part of 2003. At all times relevant to this Complaint, Ernst & Young was aware, or should have been aware, that Western United was required by law to file its audited statutory financial statements and annual reports with the OIC and that the OIC would rely on these audited and reviewed financial statements for, among other purposes, evaluating Western United's compliance with the financial requirements for conducting insurance business within the State.

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20. For fiscal years 2001 and 2002, Ernst & Young also audited the consolidated financial statements of Western United's indirect parent company, Metropolitan. Ernst & Young represented that Metropolitan's annual consolidated financial statements were audited in accordance with Generally Accepted Auditing Standards ("GAAS"), and Ernst & Young issued unqualified reports on Metropolitan's consolidated financial statements for audit years 2001 and 2002, claiming that they were prepared in accordance with Generally Accepted Accounting Principles ("GAAP"). Ernst & Young was also engaged to review Metropolitan's quarterly consolidated financial statements and did so during 2001, 2002, and part of 2003.

21. For fiscal years 2001 and 2002, Ernst & Young also audited the consolidated financial statements of Summit. Ernst & Young represented that Summit's annual consolidated financial statements were audited in accordance with GAAS, and issued unqualified reports on Summit's consolidated financial statements for audit years 2001 and 2002, claiming that they were prepared in accordance with GAAP. Ernst & Young was also engaged to review Summit's quarterly consolidated financial statements and did so during 2001, 2002, and part of 2003.

FACTUAL BACKGROUND

A. The Metropolitan Group

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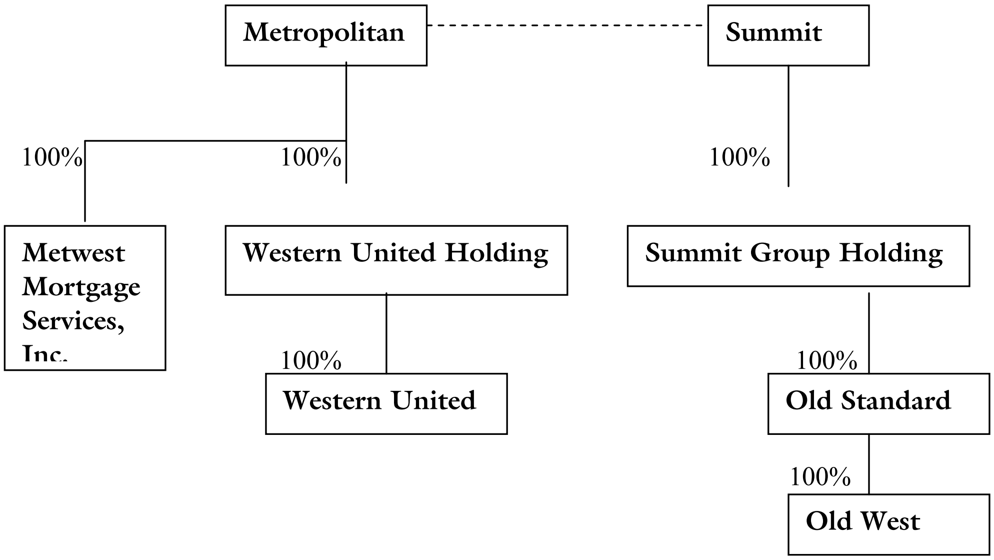
22. Metropolitan was incorporated in the State of Washington in January, 1953. Metropolitan's primary business operations included investments in and management of structured settlements and commercial and residential real estate loan portfolios, as well as commercial real estate lending and development.

23. During the period relevant to this Complaint, Metropolitan was indirectly owned and controlled by C. Paul Sandifur, Jr. (hereinafter "Sandifur"). Sandifur, through Metropolitan or otherwise, also owned and controlled, directly and indirectly, several subsidiaries of Metropolitan, all of which shared certain directors, officers, managers, and/or employees. These companies were located within the same building at 601 West First Avenue Spokane, Washington.

24. Sandifur also indirectly owned and controlled Summit, an Idaho corporation doing business in Spokane in the same building as Metropolitan and Western United. Summit is a wholly owned subsidiary of National Summit Corp. ("National Summit"), and Sandifur owned 100% of the stock of National Summit. In 1995, Summit created a wholly-owned subsidiary holding company, Summit Group Holding Company (hereinafter "Summit Group Holding"). Summit Group Holding then acquired a Metropolitan-owned subsidiary and affiliated company of Western United, Old Standard Life Insurance Company (hereinafter "Old Standard"). Summit, through Old Standard, subsequently acquired another insurance entity that became known as Old West Annuity & Life Insurance Company (hereinafter "Old West"). These companies were collectively operated, owned, and controlled by Sandifur and, together with Metropolitan and its subsidiaries, are hereinafter referred to as the "Metropolitan Group". The corporate relationships between certain of these Metropolitan Group entities can be understood as follows:



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25. Starting in or about the end of 1999, the Metropolitan Group began to devote a substantial portion of its loan business to commercial real estate lending, focusing on high-risk transactions which involved loans collateralized by various types of commercial properties (income and non-income producing), lots and land parcels (developed and undeveloped), and land held for residential development.

26. Because Sandifur served as a director and officer of the Metropolitan Group companies and/or acted as their ultimate controlling executive, he was readily able to dispense with corporate formalities and ignore clear conflicts of interests in favor of creating a "deal shop" where Western United was forced to make unsound investments to help satisfy his desire to book $100 million a month in commercial loans.

27. Western United was directed to invest revenue it received from its annuity sales business in Metropolitan-directed commercial loan activity, and to otherwise subserviate its own business decisions in favor of the interests of other Metropolitan Group companies. In particular, Western United was required to (1) pay loan originators excessive commissions for securing borrowers, regardless of the borrower's quality as a credit risk or whether the loans could ever be fully performing or repaid; (2) accept decisions of corporate underwriters outside of Western United who provided little to no supervision or review of commercial lending; and (3) rely upon property appraisals which were routinely overstated, inaccurate, or in some cases not performed at all.

28. Further, when these commercial loans defaulted or did not perform, when borrowers misused financing, and/or when property values proved to be less than their allegedly appraised value, Western United was forced to invest even more of its assets into Metropolitan Group companies in an effort to book more loans. Western United was forced to prop up Metropolitan and its commercial loan business by entering into inter-company agreements which provided additional financing on a number of suspect real estate transactions, by advancing substantial amounts of money to Metropolitan Group companies, by assuming assignment and ownership rights over properties that were worth far less than their allegedly appraised values, by paying additional loan commissions and transaction fees, by taking on the burden of foreclosing and reselling properties, and by otherwise foregoing more profitable and less risky business opportunities. Over time, Western United suffered a substantial dissipation of assets that were continually used to finance and facilitate risky commercial lending and real estate transactions.

In turn, Western United was prevented from expanding its capital base and from seeking business opportunities that would have resulted in a higher income stream at less risk.

B. Ernst & Young's Statutory Basis Audits of Western United

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29. In addition to its audits of Metropolitan and Summit, Ernst & Young was retained for the purpose of auditing the statutory-basis financial statements of Western United for the years ending December 31, 2001, 2002, and 2003.[2] Statutory accounting refers to the accounting required of insurers reporting to insurance regulatory authorities. The objectives of Statutory Accounting Principles ("SAP") differ from GAAP objectives. Whereas GAAP accounting essentially matches revenue to expenses, SAP accounting effectively measures the ability of an insurer to pay claims in the future.

30. Ernst & Young was obligated to audit the financial statements of Western United, a Washington domiciled insurer subject to State insurance regulations, "as required by this code and by the commissioner in accordance with the accounting practices and procedures manuals as adopted by the national association of insurance commissioners, unless otherwise provided by law," RCW 48.05.073, such that the statutory-basis statements could be properly prepared and filed with the OIC. RCW 48.05.250(1) ("each authorized insurer shall annually, before the first day of March, file with the commissioner a true

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[2] Ernst & Young also was engaged to audit the statutory-basis financial statements of Old Standard and Old West for the years ending December 31, 2001, 2002 and 2003.

statement of its financial condition, transactions, and affairs as of the thirty-first day of December preceding.").

31. Ernst and Young used its audits of Metropolitan and Summit, which it had allegedly conducted in accordance with GAAS, for its work on Western United's financial statements for 2001 and 2002. In essence, Ernst & Young relied upon and carried over GAAP-basis audit work performed for other Metropolitan Group companies to complete the Western United statutory-basis audits.

32. Consistent with its obligations under the insurance code, Western United filed its statutory-basis audited financial statements with the OIC for years 2001 and 2002. The OIC relied upon these Ernst & Young audited financial statements in exercising the regulatory oversight of Western United.

33. The requirements for audited financial statements filed with the OIC are set forth in Sections 284-07-100 through 284-07-230 of the Washington Administrative Code ("WAC"). The purpose of these sections is to "improve the Washington state insurance commissioner's surveillance of the financial condition of insurers by requiring an annual examination by independent certified public accountants of the financial statements reporting the financial position and the results of operations of insurers." WAC § 284-07-100.

34. Pursuant to WAC § 284-07-120, "[a]ll insurers shall have an annual audit by an independent certified public accountant and shall file an audited financial report with the commissioner on or before June 1 for the year ended December 31 immediately preceding."

35. WAC § 284-07-130 sets forth the required content of an annual audited financial report. This Section provides:

> (1) The annual audited financial report shall report the financial position of the insurer as of the end of the most recent calendar year and the results of its operations, cash flows, and changes in capital and surplus for the year then ended in conformity with statutory accounting practices prescribed, or otherwise permitted, by the commissioner.
>
> (2) The annual audited financial report shall include the following:
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> (a) Report of independent certified public accountant.
>
> (b) Balance sheet reporting admitted assets, liabilities, capital, and surplus.
>
> (c) Statement of operations.
>
> (d) Statement of cash flows.
>
> (e) Statement of changes in capital and surplus.
>
> (f) Notes to financial statements. These notes shall be those required by the appropriate NAIC Annual Statement Instructions and *NAIC Accounting Practices and Procedures Manual*. The notes shall include a reconciliation of differences, if any, between the audited statutory financial statements and the annual statement filed pursuant to RCW 48.05.250, 48.05.073, 47.36A.260, 48.43.050, 48.43.097, 48.44.095, or 48.46.080 with a written description of the nature of these differences.
>
> (g) The financial statements included in the audited financial report shall be prepared in a form and using language and groupings substantially the same as the relevant sections of the annual statement of the insurer filed with the commissioner, and the financial statements shall be comparative, presenting the amounts as of December 31. However, in the first year in which an insurer is required to file an audited financial report, the comparative data may be omitted.

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36. In addition to the annual audited financial report, an insurer's independent auditor is required to provide a report on significant deficiencies in internal controls. WAC § 284-07-190 provides in relevant part:

> [E]ach insurer shall furnish the commissioner with a written report prepared by the accountant describing significant deficiencies in the insurer's internal control structure noted by the accountant during the audit. SAS No. 60, Communication of Internal Control Structure Matters Noted in an Audit (AU Section 325 of the Professional Standards of the American Institute of Certified Public Accountants) requires an accountant to communicate significant deficiencies (known as "reportable conditions") noted during a financial statement audit to the appropriate parties within an entity. No report should be issued if the accountant does not identify significant deficiencies.

C. Ernst & Young's Resignation

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37. On or about January 20, 2004, Ernst & Young resigned as Western United's auditor and withdrew its prior statutory audits. It also resigned as the auditor for Metropolitan, Summit, and their subsidiaries and affiliated companies. In connection with its resignation, Ernst & Young stated that it believed that there existed a material weakness in the Metropolitan Group's internal controls and that senior management had misrepresented facts and failed to make known all relevant information concerning an identified transaction occurring in the fiscal year ending September 20, 2003, which resulted in an "incorrect accounting treatment for that transaction." In addition, Ernst & Young asserted that the Metropolitan Group's control environment was insufficient to deter instances where senior management may misrepresent facts or withhold relevant information, such that its resignation was appropriate under the circumstances.

38. Two weeks later, on February 4, 2004, Metropolitan and Summit filed for protection under Chapter 11 of the U.S. Bankruptcy Code in the United States Bankruptcy Court for the Eastern District of Washington. [3]

39. Prior to Ernst & Young's resignation, neither the Western United financial statements audited by Ernst & Young and filed with the OIC, nor Ernst & Young itself, ever disclosed or reported any material weaknesses or reportable conditions related to the internal controls or accounting and management practices at Western United, its direct or indirect parents, or any of its affiliated companies.

40. Neither the Western United financial statements audited by Ernst & Young and filed with the OIC, nor Ernst & Young itself, ever disclosed or reported that Western United was forced, *inter alia*, to (1) invest assets in the Metropolitan-directed commercial loan enterprise and otherwise subserviate its own business decisions in favor of those of the other Metropolitan Group companies, (2) pay loan originators excessive commissions for securing borrowers regardless of the borrower's quality as a credit risk or whether the loans could ever be fully performing or repaid, (3) accept decisions of corporate underwriters who provided little to no supervision or check on commercial lending, (4) rely upon property appraisals which were routinely overstated, inaccurate, or in some cases not performed at all, (5) enter into inter-company agreements as a means of providing additional financing on numerous suspect real estate transactions and advance substantial amounts of money to other Metropolitan Group

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[3] Metropolitan Investment Securities, Inc. ("MIS"), a wholly owned subsidiary of Summit, separately filed a

companies, (6) assume assignment and ownership rights over properties that were worth far less than their allegedly appraised values, and (7) pursue less profitable and more risky business opportunities than were otherwise available.

Chapter 7 petition on the same date.

D. Ernst & Young's Auditing Obligations

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41. The professional responsibilities of an auditor, including Ernst & Young in this case, are set forth, among other places, in GAAS, which codifies certain professional standards applicable to the auditing of financial statements. The Auditing Standards Board of the American Institute of Certified Public Accountants established GAAS. These standards must be complied with by certified public accountants auditing financial statements. These pronouncements form the ground rules for every audit, including the Ernst & Young audits of Western United, Metropolitan, and Summit.

42. There are ten auditing standards, categorized as general standards, standards of field work, and standards of reporting. The three general GAAS standards require auditors to have "adequate technical training and proficiency;" to maintain an independent state of mind in "all matters relating to the assignment;" and to exercise "[d]ue professional care . . . in the performance of the audit and the preparation of the report." Codification AU § 150.02.

43. The standards of field work require that audit work "be adequately planned;" that "the nature, timing, and extent of tests to be performed" be determined based on a "sufficient understanding of internal control;" and that "[s]ufficient competent evidential matter be obtained through inspection, observation, inquiries and confirmations to afford a reasonable basis for an opinion regarding the financial statements under audit." Codification AU § 150.02.

44. In the standards of reporting, GAAS requires that an auditor's final product – the audit report – state whether the financial statements are presented in accordance with governing accounting principles; "identify those circumstances in which such principles have not been

consistently observed in the current period in relation to the preceding period;" contain informative disclosures that are "reasonably adequate;" and include a statement of opinion by the auditor regarding the accuracy of the financial statements or explain why no opinion can be given. Codification AU § 150.02.

45. In addition to the above basic auditing standards, GAAS includes other requirements affecting all aspects of the professional services rendered by auditors. Codification AU § 150.

46. In keeping with the duty to exercise independent judgment, Codification AU § 333(a) provides that an auditor must not take client representations at face value and expressly warns that client representations cannot "substitute for the auditing procedures necessary to afford a reasonable basis for" the auditor's "opinion on the financial statements." Similarly, Codification AU § 342 holds the auditor responsible for evaluating the reasonableness of accounting estimates made by management.

47. GAAS also requires that in "all audits, the auditor should obtain an understanding of internal controls sufficient to plan the audit by performing procedures to understand the design of controls relevant to an audit of financial statements and determining whether they have been placed in operation." Codification AU § 319.02. Auditors must likewise assess the control risk of a client by "evaluating the effectiveness of an entity's internal control in preventing or detecting material misstatements in financial statements." Codification AU § 319.64. In assessing the same, GAAS acknowledges that an "entity's control consciousness is influenced significantly by the entity's board of directors or audit committee. Attributes include the board

or audit committee's independence from management, the experience and stature of its members, the extent of its involvement and scrutiny of activities, the appropriateness of its actions, the degree to which difficult questions are raised and pursued with management, and its interaction with internal and external auditors."

48. Importantly, GAAS requires the auditor to be aware of the possibility of intentional wrongdoing by management. Indeed, an auditor has "a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatements, whether caused by error or fraud." Codification AU § 110. GAAS further requires the auditor to assess the risk of fraudulent financial reporting and accounting irregularities and to respond appropriately. Codification AU § 316.

49. GAAS requires an auditor to exercise "professional skepticism" in conducting an audit, to plan for the possibility of fraud, to report potential wrongdoing to appropriate levels of authority, and to avoid the reliance upon client representations with respect to important audit issues. The importance of "professional skepticism" is a theme emphasized throughout the authoritative interpretations of GAAS, and the phrase is defined in Codification AU § 230 as "an attitude that includes a questioning method and critical assessment of audit evidence. The auditor uses the knowledge, skill, and ability called for the profession of public accounting to diligently perform, in good faith and with integrity, the gathering and objective evaluation of evidence." Codification AU§ 230 makes it clear that "professional skepticism should be exercised throughout the audit process," and that "the auditor should not be satisfied with less than persuasive evidence because of a belief that management is honest."

50. Upon detection, GAAS imposes an affirmative obligation on the auditor to bring to the attention of the audit committee of the board of directors, as well as to regulators, any significant weakness in internal controls. Codification AU § 150.

51. Statement on Auditing Standards 61, Communications with Audit Committees, lists nine matters to be discussed with the audit committee, including significant accounting policies and significant audit adjustments, disagreements with management, and auditors' awareness of management consultation with other accountants. These auditing standards require that an outside auditor discuss with the audit committee their judgments about the quality, and not just the acceptability, of a company's accounting principles. In all, the requirements for auditors' communications with audit committees are intended to foster a candid dialogue with external auditors in order to increase the likelihood that all audit committee members will be informed of matters required to be discussed.

52. For example, Codification AU § 325 requires auditors to communicate to the audit committee regarding (1) significant deficiencies in internal controls; and (2) the method to be used to account for significant unusual transactions, matters involving particularly sensitive accounting estimates, and/or significant audit adjustments. Likewise, Codification AU § 317.17 mandates that the "auditor should assure himself that the audit committee, or others with equivalent authority and responsibility, is adequately informed with respect to illegal acts that come to the auditor's attention."

53. Even where the auditor has not identified fraud, GAAS imposes on auditors an obligation to inform the audit committee about the methods used to account for significant

transactions and significant accounting policies and their application. The rule itself cites to three examples: (1) significant accounting issues that may exist in areas such as revenue recognition; (2) off-balance sheet financing; and (3) accounting for equity investments. Codification AU § 316A.

54. GAAS also expressly recognizes the possibility that management might engage in improper conduct and that "business structure and operating style are occasionally deliberately designed to obscure related-party transactions." Codification, AU § 334.05. In light of this potential for abuse, GAAS requires an auditor to "be aware of the possible existence of material related-party transactions that could affect the financial statements of a common ownership or management control relations for which" GAAP "requires disclosure." Codification AU § 334.04. To that end, in evaluating any related-party transactions, Codification AU § 334 dictates that: "The auditor should place emphasis on testing material transactions with parties he knows are related to the reporting entity," including the evaluation of "the company's procedures for identifying and properly accounting for related-party transactions" and employing procedures to "obtain satisfaction concerning the purpose, nature, and extent" of the related-party transactions "and their effect on the financial statements." In so doing, an auditor must:

a. "Obtain an understanding of the business purpose of the transaction."

b. "Examine invoices, executed copies of agreements, contracts, and other pertinent documents, such as receiving reports and shipping documents."

c. "Determine whether the transaction has been approved by the board of directors or other appropriate officials."

d. “Test for reasonableness the compliance of amounts to be disclosed, or considered for disclosure, in the financial statements.”

e. “Arrange for audits of intercompany account balances … and for the examination of specified, important, and representative related-party transactions by the auditors for each of the parties, with appropriate exchange of relevant information.”

f. “Inspect or confirm and obtain satisfaction concerning the transferability and value of collateral.”

g. “With respect to material uncollected balances, guarantees, and other obligations, obtain information about the financial capability of the other party or parties to the transaction.”

55. Further, GAAS requires that:

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> “For each material related-party transaction, … for which” GAAP “requires disclosure, the auditor should consider whether he has obtained sufficient competent evidential matter to understand the relationship of the parties and, for related-party transactions, the effects of the transaction on the financial statements. He should then evaluate all the information available to him concerning the related-party transaction or control relationship and satisfy himself on the basis of his professional judgment that it is adequately disclosed in the financial statements.”

Codification AU § 334.

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56. Ernst & Young was obligated to fulfill and comply with the requirements of GAAS when it acted as Western United’s independent auditor, as well as when it conducted the

audits of Metropolitan and Summit. Ernst and Young's audit engagement letters with Metropolitan and Summit expressly stated that Ernst & Young's audits would "be conducted in accordance with auditing standards generally accepted in the United States of America."

E. Ernst & Young's Heightened Obligations for its Audits of "High Risk" Companies

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57. When there is a heightened level of risk associated with a particular audit, the planning, testing and procedures employed by the auditor should be even more stringent than those identified above. Here, Ernst & Young knew (and, in fact, so stated on more than one occasion) that the Metropolitan Group, including Western United, was a "high risk" client necessitating heightened skepticism in planning and performing an audit if that audit was to conform with prevailing professional standards.

58. Codification AU § 316 identifies risk factors an auditor must assess in evaluating the possibility of misstatements arising from fraudulent reporting, and such factors include:

a. "An excessive interest by management in maintaining or increasing the entity's stock price or earnings trend through the use of unusually aggressive accounting practices."

b. "Significant pressure to obtain additional capital necessary to stay competitive considering the financial position of the entity – including the need for funds to finance major research and development or capital expenditures."

c. "Significant related-party transactions not in the ordinary course of business or with related entities not audited or audited by another firm."

d. "Overly complex organization structure involving numerous or unusual legal entities, managerial lines of authority, or contractual arrangements without apparent business purpose."

e. "Unusually high dependence on debt or marginal ability to meet debt repayment requirements; debt covenants that are difficult to maintain."

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59. After considering these as well as other risk factors, Ernst & Young concluded that the audits of the Metropolitan Group, including Western United, were "high risk" audits. Such a conclusion was obvious given that many of the aforementioned risk factors were prevalent within the Metropolitan Group.

60. Ernst & Young explicitly acknowledged the high risk nature of the Metropolitan Group audits, including the audits conducted for Western United, in a risk assessment report prepared by Gregory Kormanik, a member of Ernst & Young's audit team at the beginning of the 2003 audits. In that document, entitled "Internal Control and Fraud Considerations," Ernst & Young identified a number of serious internal control deficiencies and acknowledged numerous risk factors, including:

a. "Management is dominated by one or a few individuals without effective oversight by the Board of Directors or Audit Committee."

b. "Management is aggressive in selecting accounting principles and determining estimates."

c. "Managements lacks a proven track record in its business."

d. "Individual responsibility seems to be a challenge"; individual areas of the business "seems to always be a committee responsibility."

e. There is a "past history of management taking aggressive positions with regards to intercompany activity and trying to maximize income as a result of intercompany transactions. As a result of the large number of intercompany transactions that occur it is import [sic] to understands [sic] managements intent associated with such activities."

f. "The accounting, finance and IT personnel do not have the competence and training to deal with the nature and complexity of the entity's business."

g. "Lack of commitment by management to provide sufficient accounting and financial personnel to keep pace with the growth and/or complexity of the business and the demands of the stakeholders."

h. The Board of Directors does not have a charter or objectives for the Audit Committee and the Board of Directors and/or Audit Committee "are not adequately involved in the financial reporting process."

i. "Policies and procedures are not clear or issued, updated, or revised timely."

j. The existence of "significant, unusual, or highly complex transactions or innovative deals (especially those close to the year-end) that make the determination of their effects on the financial statements difficult or highly subjective or pose difficult 'substance over form' questions."

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61. Under these circumstances, Ernst & Young was obligated to increase its vigilance during its audit of the Metropolitan Group, to follow up on any possible red flags, to focus particular scrutiny on areas where internal controls might be weak and abuses might be possible, and, in general, to tailor the scope of its audit to the heightened risks identified, including the risk associated with numerous related-party transactions.

62. Codification, AU § 317.27 states:

a. "Some examples demonstrating the application of professional skepticism in response to the auditor's assessment of the risk of material misstatement due to fraud include: (a) increased sensitivity in the selection of the nature and extent of documentation to be examined in support of material transactions, and (b) increased recognition of the need to corroborate management explanations or representations concerning material matters – such as further analytical procedures, examination of documentation, or discussion with others within or outside the entity."

b. "The knowledge, skill, and ability of personnel assigned significant engagement responsibilities should be commensurate with the auditor's assessment of the level of risk of the engagement."

c. “The auditor may decide to consider further management’s selection and application of significant accounting policies . . . . In this respect, the auditor may have a greater concern about whether the accounting principles selected and policies adopted are being applied in an inappropriate manner to create a material misstatement of the financial statements.”

d. “When a risk of material misstatement due to fraud relates to risk factors that have control implications, the auditor’s ability to assess control risk below the maximum may be reduced. However, this does not eliminate the need for the auditor to obtain an understanding of the components of the entity’s internal control sufficient to plan the audit. In fact, such an understanding may be of particular importance in further understanding and considering any controls (or lack thereof) the entity has in place to address the identified fraud risk factors. However, this consideration would need to include an added sensitivity to management’s ability to override such controls.”

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63. As noted above, the conclusions of Ernst & Young’s own internal “Risk Assessment” obligated Ernst & Young to adhere to these additional precautions when conducting the audits of Western United and other companies in the Metropolitan Group.

64. Western United and the OIC reasonably relied on Ernst & Young to properly plan and conduct its work in accordance with what is required for a high risk audit and to detect and disclose any wrongdoing or issues, including but not limited to, potential disagreements between

Ernst & Young and management over disclosures or other issues in the audit and reporting process, including the wrongdoing described herein.

ERNST & YOUNG'S BREACH OF ITS DUTIES AS WESTERN UNITED'S INDEPENDENT AUDITOR

65. In rendering audit services to Western United during 2001, 2002, and 2003, Ernst & Young failed to disclose or report to Western United, the OIC, or anyone else, accounting and management deficiencies, risk control issues, material weaknesses, and reportable conditions at Western United and at its affiliated companies. Ernst & Young's failures to do so constitute violations of GAAS and breaches of its professional standard of care and the duties owed to Western United and the OIC.

A. Ernst & Young's Failure to Report Internal Control Deficiencies

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66. In evaluating Ernst & Young performance as auditor for the Metropolitan Group, the Examiner's Report focused in part on the lack of internal controls within the companies:

> The overwhelming evidence shows that Ernst & Young was confronted with an audit client that had very few, if any, effective internal controls, had a chaotic and antiquated accounting system, was rapidly expanding into a high risk commercial lending niche without any obvious background and experience, and had underwriting and lending practices that (certainly with the benefit of hindsight) were at best disorganized and at worst, reckless.

(Examiner's June 8, 2004 Report at p. 206)

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67. Former Metropolitan Group employees interviewed by the Examiner confirmed that the Metropolitan Group, including Western United, lacked any meaningful internal control procedures. For example, Tes Strunk described the group's accounting as "a big spider web of

mess and I think it always has been" and stated that if one wanted to understand a transaction, one could not learn anything from the general ledger system but would have to go directly to either Robert Ness (Metropolitan Group' former Controller) or Shannen Buerke (Metropolitan's former Accounting Manager). (Examiner's June 8, 2004 Report at p. 64)

68. Likewise, William A. Smith, Metropolitan's former Chief Financial Officer, described the "Byzantine nature" of Metropolitan's accounting systems, noting that the only way to understand a transaction would be to go to Ness, who would have to reconstruct it rather than have the answer available at his finger tips. (Examiner's June 8, 2004 Report at p. 64)

69. The Metropolitan Group had no central location for general ledger entries. Rather, the general ledger records were maintained by the individuals who had inputted them into the accounting system. During the course of his investigation, the Examiner learned that: (i) As various individuals left the employment of the group, their general ledger records would be transferred to Ness; and (ii) Many of the general ledger entries had been moved offsite into storage. (Examiner's June 8, 2004 Report at p. 64-65)

70. The Examiner concluded, based on his forensic investigation and interviews with witnesses, that "to fully understand any of [the Metropolitan Group's] transactions, it was necessary to have access either to Ness or Buerke and that answers were not readily available from the [Group's] general ledger and accounting systems." (Examiner's June 8, 2004 Report at p. 64)

71. Moreover, witnesses interviewed by the Examiner noted that "Ness had joined the Metropolitan Group as a bookkeeper and had worked his way up the corporate ladder; that the

company had grown and become very much larger and more sophisticated over that period of time; that Ness did not fully understand how technology could assist the accounting systems of the [Group]; and that generally he did not have the level of expertise or sophistication to be administering the accounting system for the [Metropolitan Group]." (Examiner's June 8, 2004 Report at p. 65)

72. According to Lona Barnum, Metropolitan's former Director of Internal Audit, the Metropolitan Group's internal controls were extremely poor when she first started working for the Metropolitan Group and only became worse over time. Moreover, Barnum told the Examiner that she frequently discussed many of these internal problems with Ernst & Young. (Examiner's June 8, 2004 Report at p. 206)

73. Nonetheless, while Ernst & Young raised various internal control issues in its management letters for the fiscal years 2001 and 2002, it never raised any of these significant issues to the level of a "reportable condition" or "material weakness." (Examiner's June 8, 2004 Report at p. 206)

74. Reportable conditions are matters coming to the auditor's attention relating to significant deficiencies in the design or operation of the internal controls that could adversely affect the organization's ability to record, process, summarize and report financial data consistent with the assertions of management in the financial statements. Codification AU § 325.02-03.

75. A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the

financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Codification AU § 325.

76. Ernst & Young's failure to raise to the level of a reportable condition or a material weakness the internal control deficiencies discovered during its audit of the Metropolitan Group, including Western United, was a violation of GAAS and a breach of Ernst & Young's professional standard of care and the duties that Ernst & Young owed to Western United and the OIC.

77. Moreover, aside from the formal management letters, Ernst & Young gave other affirmative assurances that there were no significant internal control problems within the Metropolitan Group.

78. For example, according to the minutes of the August 2002 meeting of Metropolitan's Audit Committee, Jack Behrens, Ernst & Young's engagement partner, stated that "it is incumbent upon companies today to have substantial processes embedded in accounting and review systems so that good documentation and a clear trail is evident when loan losses occur." Gary Brajcich, a member of Metropolitan's Board of Directors and Audit Committee, "inquired whether management had provided Ernst & Young with good documentation for review and asked Mr. Behrens if he was comfortable with the documentation. Mr. Behrens replied in the affirmative."

79. Notwithstanding the forgoing, Ernst & Young was well aware of the material weaknesses in the accounting and finance structure of the Metropolitan Group, including Western United. Indeed, as noted previously, Ernst & Young's audit team prepared a risk

assessment report entitled "Internal Control and Fraud Considerations" that explicitly identified a number of serious concerns and issues relating to the Company's internal controls. (Examiner's June 8, 2004 Report at p. 207)

80. Moreover, Elaine Hoskin informed the Examiner that, when she was contacted by Ernst & Young in July or August 2003 (after she resigned as the Metropolitan Group's Chief Operating Officer), she raised a number of issues with the Ernst & Young audit team that should have put Ernst & Young on notice that at least one member of senior management had serious concerns about significant aspects of the Metropolitan Group's business and accounting practices, including its aggressive lending and loan loss reserve practices. (Examiner's June 8, 2004 Report at p. 207)

81. The Examiner concluded that "it does not appear that Ernst & Young took any action with respect to this communication and, indeed, by its own admission, Ernst & Young did not start asking any hard questions of the Company until about October 2003 (during the course of the FYE 2003 audit), after [William] Smith, as the new CFO, had already started raising issues." (Examiner's June 8, 2004 Report at 207)

82. Ernst & Young did not report a material weakness in internal controls to the Audit Committee until it resigned as the Metropolitan Group's auditors on January 20, 2004.

83. Ernst & Young's failures to report these and other internal control deficiencies constitute a violation of GAAS and a breach of Ernst & Young's professional standard of care and the duties that Ernst & Young owed to Western United and the OIC.

B. Ernst & Young's Failures With Respect to Specific Transactions.

1. The Everett/Live Oak Transactions

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84. During the last four months of calendar year 2003, an internal audit investigation resulted in the reversal of a gain of approximately $10 million which was recorded at the end of fiscal-year 2002, with a resulting material adverse impact on the Metropolitan Group's previously reported and audited income for 2002, including the income of Western United. (Examiner's June 8, 2004 Report at pp. 210-13)

85. The $10 million gain was recorded in 2002 as the result of the supposed sale by the Metropolitan Group of two assets – certain property in Live Oak, Texas (the "Live Oak" property) and property near Everett, Washington (the "Everett" property) (together, the "Everett/Live Oak transaction"). (Examiner's June 8, 2004 Report at p. 210-11)

86. The Everett/Live Oak transaction was a transparent attempt to accomplish two improper accounting objectives: (i) Report a large gain in income through a fiscal year-end transaction; while (ii) Disguising the uncreditworthiness of one of the Metropolitan Group's, and particularly Western United's, largest borrowers. (Examiner's June 8, 2004 Report at p. 210-11)

87. In July 2001, Trillium Corporation ("Trillium"), a real estate investment and development company based in Bellingham, Washington, borrowed $20 million from Western United and $5 million from Metropolitan (collectively, the "Trillium Loans") to purchase certain unimproved property located in Denver, Colorado (the "Trillium Commons" property). The Trillium Loans were secured by the Trillium Commons property. (Examiner's June 8, 2004 Report at p. 211-13)

88. By the spring of 2002, Trillium was experiencing liquidity issues and was exploring a number of refinancing or capitalization options. In particular, the Trillium Loans were either already in default or about to go into default. (Examiner's June 8, 2004 Report at p. 211-13)

89. In or about May 2002, discussions began between Trillium and the Metropolitan Group regarding a possible joint venture as a means to refinance certain Trillium debt and to create the appearance of liquidity for Trillium. (Examiner's June 8, 2004 Report at p. 211-13)

90. By early summer of 2002 it was envisioned that Trillium would contribute to the joint venture: (i) the Trillium Commons property and (ii) certain undeveloped timber properties owned by Trillium in Washington State (the "Trillium Timber" properties); and that the Metropolitan Group's contribution would include (i) a loan to Trillium from the group's insurance subsidiaries and (ii) the generation of significant income for the Metropolitan Group through the sale to Trillium of the Live Oak and Everett properties. (Examiner's June 8, 2004 Report at p. 211-13)

91. A consistent objective throughout the negotiations was that the deal close by the end of September 2002, the end of the fiscal year, so that the Metropolitan Group could report the gain from the sale of the Everett and Live Oak properties in the 2002 annual financial statements. Indeed, this gain, which was the most substantial and material gain of the Metropolitan Group related to a single transaction for fiscal-year 2002, was essential in order to avoid a year-end loss for Metropolitan. (Examiner's June 8, 2004 Report at p. 211-13)

92. Meanwhile, during the summer of 2002, David Sandy, another real estate investor/developer and a friend of Trillium's principal, advanced funds to Trillium for operations (the "Sandy Loans"), which funds were secured by various Trillium assets, including liens on the Trillium Timber properties. As a result, a significant element of the proposed joint venture between Trillium and the Metropolitan Group was that the Metropolitan Group would advance funds to be secured by the Trillium Timber properties, a portion of the proceeds of which would be used to retire Trillium's debt to Sandy. (Examiner's June 8, 2004 Report at p. 212-13)

93. In September 2002, Sandifur discussed the proposed joint venture with Ernst & Young's engagement partner, Jack Behrens. Behrens informed Sandifur that Metropolitan would not receive current gain treatment for the Everett/Live Oak transaction if the properties were sold into the proposed joint venture. (Examiner's June 8, 2004 Report at p. 210)

94. Statement of Financial Accounting Standards No. 66 ("SFAS 66") governs the recognition of a company's gain or loss on sales of real estate and determines when a company can immediately recognize the gain from the sale of real estate. In order for the gain on a real estate sale to be fully and immediately recognizable, SFAS 66 requires that the buyer pay a minimum down payment and that the funds for such a down payment do not come "directly or indirectly" from the seller-company.

95. During their September meeting, Behrens informed Sandifur that SFAS 66 would not be met with regard to the proposed Everett/Live Oak transaction because Metropolitan would be, in reality, funding 100% of the purchase price through loans or the funding of the proposed joint venture. In order to receive current gain treatment under SFAS 66 for the proposed

transaction, none of the cash being used as the down payment for the purchase of the Everett/Live Oak properties could come from Metropolitan, either directly or indirectly. (Examiner's June 8, 2004 Report at p. 210)

96. According to the Examiner's Report, in order to reach the desired accounting treatment – that is, the immediate recognition of the approximately $10 million gain from the Everett/Live Oak transaction – Sandifur, Trillium, and Sandy decided to use a straw-man entity which would be interjected into the transaction as the stand-in purchaser of the Everett/Live Oak properties in order to avoid the restrictions of SFAS 66. (Examiner's June 8, 2004 Report at p. 213)

97. On September 18, 2002, Sandy formed a shell limited liability company named Jeff Properties LLC, a company supposedly owned and controlled by Sandy's teenage son, Jeff Sandy. It was agreed that Jeff Properties would serve as the third-party purchaser of the Everett/Live Oak properties. It was, however, agreed among the parties in advance that Jeff Properties would ultimately be transferred to Trillium with a profitable return, but absolutely no risk, to Sandy. (Examiner's June 8, 2004 Report at p. 212-13)

98. Under the restructured deal, Trillium was to use a portion of the proceeds of the Trillium Timber refinancing to retire the Sandy Loans, which in turn would enable Sandy to fund Jeff Properties' payment of the 20% down payment on the purchase of the Everett/Live Oak properties. (Examiner's June 8, 2004 Report at p. 211-13)

99. The Metropolitan Group's goals and objectives in restructuring the Everett/Live Oak transaction were understood by all the parties and clearly stated in a September 13, 2002 internal Trillium memorandum summarizing the negotiations:

> The Old Standard Group needs $10MM in income before September 30 in order to show a consolidated year income. However, they are not able, nor willing, to structure future transactions in a manner giving questions to current period income recognition.

(Examiner's June 8, 2004 Report at p. 128)

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100. On September 26, 2002, the Trillium Timber refinancing closed and was funded by Old Standard, another of the Metropolitan Group's insurance subsidiaries. Although less than a month earlier the Metropolitan Group was only contemplating the advance $10 million secured by the Trillium Timber Properties, Old Standard ultimately funded $17 million. Old Standard advanced this increased sum even though the appraisal obtained by Trillium showed a total value of less than $13 million for the entire property based on its current use as timberland. (Examiner's June 8, 2004 Report at p. 133-34)

101. The Trillium Timber refinancing also included payoff instructions with respect to the Sandy Loans that indicated that the pay off to Sandy was to be in an amount equal to the funds needed by Jeff Properties as a down payment for the Everett/Live Oak transactions. The escrow agent was directed to transfer the Sandy pay off amount "to two separate escrows for the purchase of real property by Jeff Properties, LLC." Pursuant to these instructions, upon closing of the Trillium Timber refinancing, approximately $5.5 million was transferred, at the direction of Sandy, from the Timber refinancing escrow to the Everett and Live Oak purchase escrows, in

order to fund Jeff Properties' down payment obligations. (Examiner's June 8, 2004 Report at p. 134)

102. The Everett/Live Oak transaction closed the next day, September 27, 2002, with the 20% cash down payment for each of the transactions being funded from the Timber Refinancing escrow. (Examiner's June 8, 2004 Report at p. 135)

103. The 80% balance of the purchase price was evidenced by two purchase money notes and deeds of trust carried by Metropolitan Group companies, including Western United, the sellers of the properties. These notes contained suspiciously favorable terms. For example, the Jeff Property notes accrued interest at only 8% per annum, an extremely favorable interest rate compared to the Metropolitan Group's then standard 12% per annum rate. Moreover, the loan agreements provided that the Metropolitan Group would agree to the future assignment of the loans conditioned only on the requirement that the buyer was as creditworthy as Jeff Properties (a transfer restriction that Trillium's Managing Director, Lief Olsson describes as "ludicrous" given that Jeff Properties was a recently-formed shell corporation with no assets other than the Everett and Live Oak properties). (Examiner's June 8, 2004 Report at p. 134-37)

104. On October 2, 2002, Trillium transferred (through affiliated entities) approximately $5.5 million to Sandy to reimburse Sandy for the funds he invested in Jeff Properties, and ultimately Trillium acquired the Everett/Live Oak properties subject to the Jeff Properties notes. (Examiner's June 8, 2004 Report at p. 140)

105. By the end of the first calendar quarter of 2003, all of the Metropolitan Group's loans with Trillium and Jeff Properties were either in or about to go into default. (Examiner's June 8, 2004 Report at p. 140-41)

106. Nonetheless, the Metropolitan Group reported an approximately $10 million gain as a result of the Everett/Live Oak transaction for fiscal year 2002. Western United itself reported a $7.87 million gain (which has since been reversed) on the supposed sale of the Live Oak property to Jeff Properties. (Examiner's June 8, 2004 Report at p. 141-43)

107. Ernst & Young violated GAAS, its professional standard of care, and the duties owed to Western United and the OIC through its approval of SFAS 66 treatment for the Everett/Live Oak transaction, which enabled the Metropolitan Group, including Western United, to falsely report a gain for fiscal-year 2002 in the annual financial statements filed with the OIC.

108. In his review of Ernst & Young's conduct with regard to the accounting treatment approved for the Everett/Live Oak transaction, the Examiner noted that:

> [T]he following significant facts do appear to be largely uncontroverted (either admitted by [Jack] Behrens [Ernst & Young's engagement partner] during the course of his interview in connection with the Examination or admitted to as facts known to Ernst & Young at or about the time the Everett/Live Oak Transaction closed, as set forth in [a] memorandum from Behrens and Kormanik to the Metropolitan working paper files):
>
> (a) The [Metropolitan Group] had a significant desire to create a very significant year-end current gain from a sale of Everett/Live Oak to Trillium. The anticipated gain would likely be by far and away the largest gain generated by any single transaction during the entire fiscal year.
>
> (b) Metropolitan Group . . . had proposed a number of different transaction structures involving a joint venture with Trillium but Ernst & Young indicated that none of them satisfies the SFAS 66

> requirement for current gain recognition "for a number of substantive reasons including the initial investment and continuing involvement criteria."
>
> (c) Shortly thereafter, [the Metropolitan Group] identified a new purchaser (Jeff Properties) to purchase Everett/Live Oak. By its own admission, Ernst & Young knew:
>
> (i) Jeff Properties was related to Dan Sandy (Ernst & Young's memorandum describes the purchaser as "Jeff Properties (Dan Sandy)").
>
> (ii) Dan Sandy was a creditor of Trillium.
>
> (iii) Contemporaneous with the Everett/Live Oak transaction, Old Standard would be making a substantial loan to Trillium, part of the proceeds of which would be used to pay off approximately $6 million of loans held by Dan Sandy on the underlying real estate.
>
> (iv) Ernst & Young either knew or should have known that Jeff Properties was only recently formed and had no assets other than those to be contributed by Dan Sandy.

(Examiner's June 8, 2004 Report at p. 210-11)

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109. Indeed, just prior to closing the restructured Timber Refinancing and Everett/Live Oak transactions, Ernst & Young's engagement partner, Jack Behrens, was specifically asked to provide assurances that the newly structured transactions would receive the desired accounting treatment. According to a participant in the conversation with Behrens, who was interviewed by the Examiner, Behrens was informed "about the Timber Refinancing, that Sandy would be paid off from that transaction and that Sandy would be acquiring Everett and Live Oak, and asked Behrens 'is that far enough apart?'" According to the witness interviewed by the Examiner, Behrens responded during the call, "that looks fine to me. That's far enough apart." (Examiner's June 8, 2004 Report at p. 210-12)

110. In addition to the above facts and circumstances admittedly known by Ernst & Young at the time of the Everett/Live Oak transaction, the Examiner also noted additional significant "red flags" ignored by Ernst & Young. (Examiner's June 8, 2004 Report at p. 219)

111. One example was the speed with which an alternative, supposedly "independent" buyer was located after Ernst & Young advised that a joint venture with Trillium would not satisfy Metropolitan's income needs. Ernst & Young advised Metropolitan that a joint venture would not generate a current gain on the sale of the Everett and Live Oak properties in the early part of September 2002 and yet, by mid-September 2002 an independent purchaser, supposedly satisfying SFAS 66, had been found by Metropolitan. (Examiner's June 8, 2004 Report at p. 210)

112. Other highly suspicious aspects of the transactions overlooked by Ernst & Young include: (i) The low market interest rate charged by Metropolitan with respect to the purchase money notes and deeds of trust signed by Jeff Properties; and (ii) The highly questionable appraisal purportedly supporting and justifying the Timber Refinancing. (Examiner's June 8, 2004 Report at p. 211)

113. Indeed, during the audit process, Ernst & Young inquired as to the basis for the highly favorable financing terms of the Jeff Properties loans. In November 2002, Theodore Anderson of Ernst & Young sent an email to Kormanik noting:

> It appears that last year all commercial loans with principal balances $5 million and $10 million had interest rates greater than 12%. This year the weighted average commercial loan interest rate is about 15% . . . if this is the case then it does seem strange that the Jeff Properties Loans are at 8%.

(Examiner's June 8, 2004 Report at p. 212)

114. The Examiner found the justifications provided by the Metropolitan Group for the lower interest rate were far from convincing, especially under the circumstances known to Ernst & Young at the time of the Everett/Live Oak transactions, given that the primary justification provided was that "[t]he purchaser has a successful history in commercial property developments and has access to sufficient amounts of liquidity." The Examiner rightly found this justification "meaningless" in that (i) the loans were freely assignable to an entity or individual without any such history, and (ii) Jeff Properties was a newly formed shell company that owned no other assets other than the Everett and Live Oak properties. (Examiner's June 8, 2004 Report at p. 212-13)

115. Thus, the Examiner concluded: "[I]t appears that Ernst & Young knew or should have known that the critical 20% down payment for the Everett/Live Oak Transaction was being "indirectly" funded by the seller." (Examiner's June 8, 2004 Report at p. 213)

116. The opinions given by Ernst & Young allowing for SFAS 66 treatment of the Everett/Live Oak transactions and immediate gain recognition for those transactions was improper and constituted a violation of GAAS and of Ernst & Young's professional standard of care, as well as a breach of the duties that Ernst & Young owed to Western United and the OIC.

2. The "Rabbits" – Other Transparent End-of-Year Transactions Designed To Create The Appearance of Large Fiscal Year-End Gains

117. In addition to the Everett/Live Oak transaction detailed above, the Examiner's investigation uncovered "a pattern of significant year-end sales of Metropolitan Group's [real

estate and development] properties in FYE 2002 and FYE 2003, designed to create large fiscal year-end gains." (Examiner's June 8, 2004 Report at p. 59)

118. The Examiner discovered that this practice was "well known within the Metropolitan Group and well documented in spreadsheets used . . . to monitor year-end transactions." (Examiner's June 8, 2004 Report at p. 13)

119. Indeed, these transactions were so critical to the Metropolitan Group's reported financial performance that Sandifur coined the expression "rabbits" to refer to these important year-end transactions – a reference to the ability to "magically" pull a rabbit out of the hat in order to meet year-end fiscal objectives. (Examiner's June 8, 2004 Report at p. 157)

120. As a result of the improper rabbit transactions, the Examiner concluded: "[M]ore likely than not, if not already reversed, approximately $14 million of gains recognized by Metropolitan in FYE 2002 from year end sales (of which slightly more than $11 million was reported by Western United) will need to be reversed and the bulk of this reversal will likely be permanent, rather than simply a matter of timing." There are also substantial gains recorded in fiscal-year 2003, which either have been, or will have to be, reversed. (Examiner's June 8, 2004 Report at 156-57).

121. Other than the Everett/Live Oak transaction, the largest such rabbit transactions – the Silver Canyon/Grand Hills and Neighborhood transactions – are described below. The opinions and approvals provided by Ernst & Young regarding the immediate gain accounting treatment for these and other similar large year-end transactions violated GAAS and Ernst &

Young's professional standard of care and breached the duties that Ernst & Young owed to Western United and the OIC.

a) The Silver Canyon/Grand Hills Transaction

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122. Pursuant to an agreement dated April 30, 2002, an individual by the name of William Ragland and/or an affiliated partnership known as Grand Hills Holding LLC (collectively, "Grand Hills") acquired the right to purchase from the Silver Canyon Partnership parcels of land located within a real estate development on the outskirts of Las Vegas (the "Silver Canyon" property) for a purchase price of $7.5 million. (Examiner's June 8, 2004 Report at p. 166)

123. By the time of the closing date, September 15, 2002, Grand Hills had made non-refundable deposits of $750,000 but was unable to finance the balance of the purchase price through its broker. Thus, Grand Hills approached Old Standard for a bridge loan to enable Grand Hills to acquire the Silver Canyon property and then obtain permanent financing. (Examiner's June 8, 2004 Report at p. 166-67)

124. Old Standard made an initial proposal whereby Old Standard would purchase the entire Silver Canyon property for $6.8 million (*i.e.* the negotiated purchase price of $7.5 million, less the non-refundable deposits funded by Grand Hills) and would in turn grant Grand Hills an option to purchase the entire property "in an amount $2 million more than the Old Standard's purchase price," to be exercised within one year, and requiring the payment of 1% of the purchase price advanced by Old Standard per month (*i.e.*, an annual effective interest rate of 12%) to keep the option in effect. (Examiner's June 8, 2004 Report at p. 167)

125. Notwithstanding the structuring of the proposed transaction as a purchase by Old Standard of the Silver Canyon property and the granting of an option to Grand Hills to acquire the underlying property at a premium, the essence of the transaction was clearly a financing, rather than the purchase and sale of real estate by Old Standard. (Examiner's June 8, 2004 Report at p. 168)

126. On September 23, 2002, a revised proposal by the Metropolitan Group introduced a new concept whereby Old Standard would immediately sell six unspecified Silver Canyon lots to Grand Hills for $3.5 million, essentially creating the $2 million profit contemplated in the initial proposal, but creating it immediately, before the Metropolitan Group's fiscal year end. (Examiner's June 8, 2004 Report at p. 168)

127. Two days later the proposal was again modified to include for the first time the participation of Western United. Under the new proposal (which was how the deal was ultimately structured and executed): (i) Western United would purchase six lots of the Silver Canyon property for $1.5 million and immediately sell those lots to Grand Hills for $3.5 million, with a 20% down payment to be financed by the non-refundable deposits already made by Grand Hills into escrow and the balance of $2.8 million financed by Western United through a promissory note, bearing interest at 12% per annum; and (ii) Old Standard would purchase the remaining twenty-seven lots of the Silver Canyon property for $6 million and grant Grand Hills an option to purchase those lots for $6.5 million within three months, extendable at a cost of $65,000 per month (or effectively 13% per annum on the $6 million purchase price financed) for up to eighteen months. (Examiner's June 8, 2004 Report at p. 168-69)

128. The Examiner found that "it clearly appears that the identity of the six lots subject to the purchase and sale (rather than the purchase and option) portion of the overall transaction was not dictated by any meaningful negotiations between Old Standard and Grand Hills." Indeed, at the very last minute, the lots were changed from Lots 1 through 6 to Lots 1, 2, 3, 4, 30 and 31, without any consideration to the effect of the value of the deal or any substantive negotiation between the parties. (Examiner's June 8, 2004 Report at p. 169-70)

129. The transaction described above closed on September 27, 2002. Western United recognized a year-end gain of $1,790,350 based on the sale of the six Silver Canyon property lots.

130. As of March 2003, Grand Hills stopped making payments on the Western United note, as well as the extension charges on the Old Standard option. Western United repossessed the six Silver Canyon property lots, and Old Standard still possesses the other 27 lots. Ultimately, after the resignation of Ernst & Young, Western United reversed the prior-recognized gain from Silver Canyon/Grant Hill transaction. (Examiner's June 8, 2004 Report at p. 170)

131. The Examiner's preliminary investigation of this transaction concluded that "[i]t appears highly likely from the evidence reviewed . . . that the Silver Canyon/Grand Hills transaction was both intended to be, and in substance functioned as a secured loan (albeit at extremely high effective interest rates) rather than a true purchase and sale of property. In effect, the transaction was driven by Grand Hills' need to obtain 'bridge financing' in order to exercise

its purchase agreement with Silver Canyon before the agreement expired and it forfeited its good faith deposits." (Examiner's June 8, 2004 Report at p. 171).

132. The Examiner also found that "the allocation of a $3.5 million to the [six Silver Canyon lots purchased and resold by Western United] (the identity of which was changed at the last minute as a result of Grand Hills' development needs rather than any consideration of value) was purely arbitrary and seemingly designed to create an immediate 'gain' for Western United." (Examiner's June 8, 2004 Report at p. 171).

133. The Examiner concluded that the "unreasonableness of the gain is made obvious not only by the fact that Western United purchased and sold the lots for an almost $2 million profit on the same day, but that the remaining lots were optioned by Old Standard to Grand Hills at a substantially lower profit." (Examiner's June 8, 2004 Report at p. 171).

134. As one of the four largest year-end transactions (together with the Everett/Live Oak transactions discussed above and the Neighborhood transactions discussed below), Ernst & Young examined at least the sales portion of the Silver Canyon/Grand Hills transaction and concluded that a current gain of $1.8 million had correctly been recorded by Western United.

135. After noting the aforementioned red flags regarding this transaction, which were apparently ignored by Ernst & Young, the Examiner concluded that:

> Certainly, if Ernst & Young had reviewed the entire Silver Canyon Transaction (a fact which the Examiner has not yet determined) it would have become self-evident that not only should the transaction more appropriately have been characterized as a loan rather than the purchase and sale of real estate, but that the extraordinary gain generated by the Metropolitan Group for its FYE 2002 financial statements resulted in an obvious and deliberate misallocation of basis among the thirty-three lots comprising the entire transaction.

(Examiner's June 8, 2004 Report at p. 171)

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136. Ernst & Young's approval of the approximately $1.8 million year-end gain recognized by Western United as a result of the Silver Canyon/Grand Hills transaction violated GAAS and Ernst & Young's professional standard of care and breached the duties that Ernst & Young owed to Western United and the OIC.

b) The Neighborhood Transactions

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137. Compounding Ernst & Young's violations of GAAS and its duties to Western United and the OIC was Ernst & Young's approval of the current gain treatment with respect to the Neighborhood transactions, which involved a similar course of misconduct as the Everett/Live Oak transaction, namely the use of one Metropolitan Group entity to make a loan, the proceeds of which were used to fund the 20% down payment by the borrower on the purchase of real estate from another Metropolitan Group entity and the creation of substantial year-end gain. (Examiner's June 8, 2004 Report at p. 172)

138. Specifically, pursuant to a purchase and sale agreement dated as of June 16, 2002, Metropolitan agreed to sell to an entity known as Neighborhood, Inc. ("Neighborhood") certain real property located in Franklin County, Washington (the "Franklin County" property) for a total purchase price of $2,025,350. (Examiner's June 8, 2004 Report at p. 172-73)

139. Pursuant to the purchase and sale agreement, each transaction was to be funded with a 20% cash down payment ($405,070) with Metropolitan carrying back purchase money notes and deeds of trust for the balance of the purchase price. (Examiner's June 8, 2004 Report at p. 173)

140. Concurrently, Summit loaned $656,250 to Neighborhood, secured by certain real property owned by Neighborhood located in Rathdrum, Idaho (the "Idaho" property). Of this advance, approximately $251,180 was used by Neighborhood to pay off an existing secured loan and the balance ($405,070) was used to fund the down payment for the purchase of the Franklin County property from Metropolitan. (Examiner's June 8, 2004 Report at p. 173)

141. It was no secret that the Summit loan was being made in order to fund Neighborhood's down payment with respect to its real estate acquisitions from Metropolitan. Numerous documents relating to the transactions, including the Loan Summary for the Summit loan, the Loan Work Sheet, the Financing Request/Project Overview and the Escrow Instructions, demonstrated that it was both contemplated and expected that the Summit loan would fund the down payment for Neighborhood's purchase from Metropolitan. (Examiner's June 8, 2004 Report at p. 173-74)

142. While the Summit loan was supposedly premised on an $875,000 value for the Idaho property, no appraisal was completed before the loan was funded. (Examiner's June 8, 2004 Report at p. 173)

143. Ernst & Young approved immediate gain treatment for this transaction supposedly on the basis that the loan by Summit did not constitute an indirect provision of funds by Metropolitan in contravention of SFAS 66. (Examiner's June 8, 2004 Report at p. 175-77).

144. The Examiner found any such conclusion "unfounded . . . especially in light of the fact that the Summit loan and the Metropolitan asset sale were clearly related and coordinated transactions and that it would have been abundantly clear to anyone familiar with the workings and operations of the Metropolitan Group that Summit did not, and could not act independently of Metropolitan and that, in essence, Sandifur . . . treated the assets of the constitute members of the Metropolitan Group as largely interchangeable." (Examiner's June 8, 2004 Report at p. 175-77)

145. In September 2002, Western United agreed to sell another portion of the development located in Franklin County, Washington (the "Second Franklin County" property) to Neighborhood for a total purchase price of $3,468,125, with 20% of the purchase price being funded in cash and the balance being carried by Western United in the form of a purchase money note and deed of trust. (Examiner's June 8, 2004 Report at p. 175-77)

146. As with the sale of the initial Franklin County property, the down payment for the purchase of the Second Franklin County property was again funded by Summit, this time by making a loan in the amount of $713,625, secured by a lien junior to the purchase money lien of Metropolitan on a portion of the initial Franklin County property (the "Franklin County Security" property). (Examiner's June 8, 2004 Report at p. 175-77)

147. The Franklin County Security property had been sold by Metropolitan to Neighborhood less than three months earlier for a purchase price of approximately $1.5 million. After the closing of the Summit loan, debt held by Metropolitan and Summit and secured by this property totaled more than $1.9 million. (Examiner's June 8, 2004 Report at p. 175-77)

148. As with the sale of the initial Franklin County property, Ernst & Young approved immediate gain treatment for the sale by Western United of the Second Franklin County property, which enabled Western United to report a $1.47 million year-end gain. (Examiner's June 8, 2004 Report at p. 175-77)

149. Regarding Ernst & Young's conduct with regard to the above-described Neighborhood transactions the Examiner concluded:

> [T]he lack of oversight by Ernst & Young with respect to the Neighborhood transactions appears even more egregious than with respect to the [Everett/Live Oak] transactions for the simple reason that at least in the [Everett/Live Oak] transactions there was an attempt to interpose a “straw man” (namely Jeff Properties) between the source and the use of the down payment, whereas the Neighborhood transactions involved no such artifice; funds were advanced by Summit to Neighborhood on the very same day that Neighborhood used those funds as a down payment to purchase [real estate] from another member of the Metropolitan Group.

(Examiner’s June 8, 2004 Report at p. 176-77)

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150. The opinions and approvals provided by Ernst & Young regarding the immediate gain accounting treatment for the Neighborhood transactions, and other year-end real estate transactions that were reported in violation of SFAS 66, violated GAAS and Ernst & Young’s professional standard of care and breached the duties that Ernst & Young owed to Western United and the OIC.

C. Other Known Material Accounting Deficiencies and Abuses To Which Ernst & Young Failed To Properly Respond

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151. In its letters and reports to the Metropolitan Group’s Management (the “Management Letters”), Ernst & Young set forth certain known issues and deficiencies with respect to the Metropolitan Group’s loan processes, gain recognition, loss reserves, and other practices and policies, all of which the Examiner has concluded “constituted material deficiencies and abuses with respect to the operations of the Metropolitan Group and all of which materially contributed to the substantial loss that investors and other creditors have to date sustained with respect to the Metropolitan Group.” (Examiner’s June 8, 2004 Report at p. 216)

152. Prior to its resignation, Ernst & Young never raised any of these issues to the level of a "reportable condition" or a "material weakness," notwithstanding, according to the Examiner, "the significant, and in some cases readily apparent, problems in the Metropolitan Group's operations and processes . . . as well as management's continuous failure to proactively and adequately rectify the issues and deficiencies noted by Ernst & Young." (Examiner's June 8, 2004 Report at p. 216)

1. Loss Reserves and Charge-Offs

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153. In the Management Letters, Ernst & Young raised various material issues regarding the Metropolitan Group's loss reserves and allowances, yet despite management's lack of responsiveness, never raised these issues to the level of reportable condition or material weakness.

154. For example, in its 2001 Management Letter, Ernst & Young only recommended that the Metropolitan Group review and consider the application of the relevant SFAS and other accounting standards and guidelines for loss recognition, loss reserves, loan impairment and other related issues.

155. Ernst & Young did not raise any specific issues or concerns at this point, and apparently was satisfied by the Metropolitan Group's response that "[a]ny applicable provision will be incorporated into the current loan loss reserve methodology." (Examiner's June 8, 2004 Report at p. 218)

156. However, in its 2002 Management Letter, Ernst & Young observed that there were no formalized policies or procedures in place relating to the determination and evaluation

of the allowance for losses on loans, and recommended that the Metropolitan Group put together such policies and procedures in order to formalize and memorialize its current process for loan loss calculations and that it should also categorize its loans showing risk from highest to lowest risk.

157. Ernst & Young was again apparently satisfied by management's response that the Metropolitan Group would implement such policies by March 31, 2003. (Examiner's June 8, 2004 Report at p. 216-20)

158. Ernst & Young also observed, "During fiscal 2002, the Company experienced significant growth in commercial lending and combined its allowance for loan loss into one account for all receivables, including commercial and residential loans, lottery prizes, and structured settlements. Although supporting information related to all portions of the portfolio were ultimately obtained, it did not result without a significant management effort at year-end."

159. Related to this, Ernst & Young recommended that the Metropolitan Group should have monthly and quarterly reports related to loss allowance to assist with the loan-monitoring process, portfolio aging information, delinquency information and trends by portfolio, various trend analysis, historical information to facilitate trend analysis, and a listing of loans charged off during the period.

160. Despite these known material deficiencies, the Examiner determined that "it does not seem Metropolitan Group ever implemented a clear, consistent, supportable loan reserve and allowance process." (Examiner's June 8, 2004 Report at p. 216-18)

161. The Examiner also noted that "[i]t is unclear what, if any, measures Ernst & Young took in following up with the Metropolitan Group on the implementation of such a process." (Examiner's June 8, 2004 Report at p. 218)

162. Notwithstanding the known material deficiencies in the adequacy of the Metropolitan Group's loan loss reserves, in a Summary Review Memorandum dated as of September 30, 2003, Ernst & Young still concluded that the Metropolitan Group's loan loss reserve procedures "are considered adequate to provide a basis for assessing the reasonableness of the Company's allowance for loan loss." (Examiner's June 8, 2004 Report at p. 218)

2. Appraisals of Real Estate Held for Sale

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163. In several of its Management Letters, Ernst & Young observed problems in the Metropolitan Group's appraisal process, including the lack of recent or updated appraisals for some properties and inconsistent valuation support in the company's loan files. Aside from the problem of stale appraisals, the Examiner determined that the Metropolitan Group's appraisal process was seriously deficient and flawed. (Examiner's June 8, 2004 Report at p. 218)

164. As a result, the Examiner has concluded that "the magnitude of the problems in the appraisal process was so significant that Ernst & Young reasonably should have, among other things, raised more concerns and 'red flags' with management." (Examiner's June 8, 2004 Report at p. 218-19)

3. Gain Recognition

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165. Ernst & Young never raised any issues regarding gain recognition in its Management Letters.

166. However, as discussed in detail above, the Metropolitan Group improperly recognized material gains with respect to significant fiscal-year 2002 year-end transactions, e.g., the Everett/Live Oak transactions, the Silver Canyon/Grand Hills transaction, and the Neighborhood transactions.

4. Loan Process

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167. Ernst & Young provided very little comment in its Management Letters with respect to the Metropolitan Group's commercial loan process, simply noting that the company's loan files and records were inconsistently organized and maintained and, in some cases, incomplete. (Examiner's June 8, 2004 Report at p. 219)

168. However, the Examiner determined that "the Metropolitan Group's commercial loan process was materially flawed in many respects; the Examiner believes that such flaws and weaknesses would have been self-evident in any detailed and meaningful review of the Metropolitan Group's loan files and records. (Examiner's June 8, 2004 Report at p. 219)

5. System and General Ledger Processes

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169. In its 2001 Management Letter, Ernst & Young observed,

> During our audit, we noticed a number of areas in which additional resources may improve productivity, efficiency, and effectiveness. The

> accounting and reporting functions rely principally on two employees. We noted a number of occasions where delays were caused because the accounting staff did not have enough manpower resources. We would caution against placing too much reliance on too few people to provide timely and accurate financial reporting.

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170. The Examiner properly concluded that "[i]n light of this Byzantine, after-the-fact process implemented by the Metropolitan Group . . . Ernst & Young's scrutiny and review should have been substantially more rigorous than it appears to have been." (Examiner's June 8, 2004 Report at p. 219-20)

171. In summary, Ernst & Young failed to raise to the level of a "reportable condition" or a "material weakness" known and pervasive accounting deficiencies and abuses that Ernst & Young observed during the course of its audits. These failures violated GAAS and Ernst & Young's professional standard of care and breached the duties that Ernst & Young owed to Western United and the OIC. (Examiner's June 8, 2004 Report at p. 219-20)

COUNT I

(Negligence)

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172. Plaintiff repeats and realleges the foregoing paragraphs 1 through 171 above as if fully set forth herein.

173. Ernst and Young owed a duty to Western United and the OIC to perform its audits according to the standards, and with the degree of care, which generally prevailed in the accounting profession during the period covered by the respective audits.

174. Ernst and Young knew or should have known that, among others, Western United and OIC would rely upon the information set forth in the audited financial statements filed on behalf of Western United with the OIC for, among other purposes, determining and monitoring Western United's financial condition.

175. The auditing services rendered by Ernst & Young in connection with its audits of Western United were performed negligently and carelessly because, as detailed above, they: (i) Failed to conform with GAAS; (ii) Were not performed with the degree of skill and care commonly applied by and expected from other accounting firms under similar circumstances; (iii) Were not performed with the degree of skill and care that Ernst & Young held itself out as possessing; and (iv) Were not performed with the degree of skill and care called for by Ernst & Young's own internal policies and procedures.

176. Ernst & Young's negligence includes, but is not limited to: (i) The manner in which it conducted its audits and its reviews of the consolidated financial statements and other information for Western United; (ii) Its failure to report known and significant internal control deficiencies or to raise those issues to the level of a reportable condition and material weakness; (iii) The opinions given and approval provided allowing for SFAS 66 treatment of and immediate gain recognition for the Everett/Live Oak transactions; (iv) The opinions given and approvals provided allowing for SFAS 66 treatment of and immediate gain recognition for the Silver Canyon/Grand Hills and Neighborhood transactions and other similar transactions; (v) Its failure to report known material misstatements in the Metropolitan Group's reported financial statements, including the annual financial statements that Western United filed with the OIC,

resulting from inter-company transactions with the Metropolitan Group designed solely for the purpose of generating paper profits; (vi) Its failure to elevate to the level of reportable conditions and material weakness numerous other known accounting deficiencies and abuses observed during its audits; and (v) Its misrepresentation that it had conducted its audits in accordance with GAAS, that the financial statements it audited were fairly presented in all material respects with GAAP, and that Western United's financial statements were presented in accordance with statutory accounting principals required under the insurance laws of Washington.

177. As a direct and proximate result of Ernst & Young's negligence, Western United has suffered and continues to suffer substantial harm and is entitled to recover from Ernst & Young damages in amount to be proven at trial. Such damages include, but are not limited to, an award of lost revenues, profits, and property, and compensation for lost business opportunities and asset dissipation suffered by Western United, as well as the indemnification of all sums incurred and expended in connection with the rehabilitation of Western United, plus costs of suit and attorneys fees, and all other or further relief allowed by law.

COUNT II

(Negligent Misrepresentation)

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178. Plaintiff reasserts and realleges the allegations set forth in paragraphs 1 through 171 and 173 through 177 above as if fully set forth herein.

179. For fiscal years 2001and 2002, Ernst & Young issued audit reports to the audit committee of Western United. In each fiscal year, Ernst & Young issued unqualified audit reports in which Ernst & Young made the following material representations, among

others: (i) That it had audited Western United's financial statements in accordance with GAAS; (ii) That as part of its audit, Ernst & Young obtained an understanding of internal controls sufficient to plan its audit and to determine the nature, timing, and extent of testing performed; (iii) That it had planned and performed those audits to obtain reasonable assurance about whether the financial statements are free of material misstatements; (iv) That, in its opinion, Western United's statutory-basis financial statements present fairly, in all material respects, the financial position of Western United; and (v) That its audits provided a reasonable basis for its opinions.

180. In each year, Western United filed Ernst & Young's unqualified audit report with the OIC along with its audited financial statements. At the time that Ernst & Young prepared and issued these unqualified audit reports, Ernst & Young knew that they would be included with Western United's OIC filing and relied upon by OIC for, among other things, determining and monitoring Western United's financial condition.

181. At the time that Ernst & Young issued these audit reports, Ernst & Young knew or should have known that the above material representations were false, and/or Ernst & Young negligently disregarded whether these representations were true. Ernst & Young nevertheless issued these audit reports containing these negligent material misrepresentations with full knowledge and intention that they would be relied upon by Western United and the OIC.

182. At all relevant times, Western United and the OIC justifiably relied on Ernst & Young's material misstatements in determining, among other things, that Western United was not in need of a special examination and/or an order of supervision or receivership.

183. As a direct and proximate result of Ernst & Young's negligent misrepresentations, Western United has suffered and continues to suffer substantial harm and is entitled to recover from Ernst & Young damages in amount to be proven at trial. Such damages include, but are not limited to, an award of lost revenues, profits, and property, and compensation for lost business opportunities and asset dissipation suffered by Western United, as well as the indemnification of all sums incurred and expended in connection with the rehabilitation of Western United, plus costs of suit and attorneys fees, and all other or further relief allowed by law.

Count III

(Breach of Contract)

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184. Western United reasserts and realleges the allegations set forth in paragraphs 1 through 171, 173 through 177, and 179 through 183 above as if fully set forth herein.

185. For the relevant years 2001 through 2003, Ernst & Young entered into annual agreements with the Metropolitan Group, including Western United, to render professional services on behalf of the companies comprising the Metropolitan Group, including, without limitation, to audit the Metropolitan Group's consolidated financial statements and to audit Western United's statutory-basis financial statements.

186. Pursuant to those agreements, Ernst & Young specifically promised to, among other obligations:

a) Conduct its audit in accordance with GAAS,

1. Plan and perform its audit to obtain reasonable assurance about whether the financial statements are free of material misstatements, whether caused by error or fraud,

2. Obtain an understanding of internal controls sufficient to plan the audit and to determine the nature, timing, and extent of audit procedures to be performed,

3. Examine on a test basis evidence supporting the amounts and disclosures in the financial statements,

4. Report directly to the audit committee any fraud of which Ernst & Young became aware that involved senior management, and any fraud (whether caused by senior management or other employees) of which Ernst & Young became aware that caused a material misstatement of the financial statements,

5. Report to senior management any fraud perpetrated by lower level employees of which Ernst & Young became aware that does not cause a material misstatement of financial statements,

6. Inform the appropriate level of management and determine that the audit committee was adequately informed with respect to illegal acts that have been detected or have otherwise come to Ernst & Young's attention in the course of its audits, unless the illegal act is clearly inconsequential,

7. Report directly to management and the audit committee matters coming to Ernst & Young's attention during the course of its audits that were believed to be significant deficiencies in the design or operation of internal controls that could adversely affect the Metropolitan Group's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements, and

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8. Communicate to the audit committees, or determine that the audit committees are informed, about certain other matters related to the conduct of audits, including, when applicable: (a) Ernst & Young's responsibility as auditors under GAAS; (b) significant accounting policies; (c) management judgments and accounting estimates; (d) audit adjustments; (e) Ernst & Young's judgments about the quality of the Metropolitan Group's accounting principles as applied in their financial reporting; (f) other information in documents contained in audited financial statements; (g) disagreements with management; (h) consultation by management with other accountants on significant matters; (i) difficulties encountered in performing audit; and (j) major issues discussed with management prior to Ernst & Young's retention as auditors.

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187. Ernst & Young consistently breached its agreements with Western United by failing to perform its professional services in the agreed upon manner.

188. Between 2001 and 2003, Ernst & Young also entered into annual agreements with the Metropolitan Group to review quarterly consolidated financial statements of the Metropolitan Group for the first three quarters of each fiscal year.

189. Pursuant to these agreements, Ernst & Young specifically promised to: (i) Conduct its review of those financial statements in accordance with professional standards; and (ii) Render a report as to whether it was aware of any material modification that should be made in the quarterly consolidated financial statements for them to be in conformity with GAAP.

190. Starting at least as early as 2001, Ernst & Young breached its agreements with Western United by failing to conduct its review of quarterly consolidated financial statements in accordance with GAAP.

191. As a direct consequence of Ernst & Young's breach of its agreements with respect to its audit of the statutory-basis financial statements of Western United for the years 2001, 2002,

and 2003, and its agreement with respect to the reviews of the quarterly consolidated financial statements for the years 2001, 2002, and part of 2003, Western United has suffered, and continues to suffer, substantial damages and is entitled to recover from Ernst & Young damages in amount to be proven at trial. Such damages include, but are not limited to, an award of lost revenues, profits, and property, and compensation for lost business opportunities and asset dissipation suffered by Western United, as well as the indemnification of all sums incurred and expended in connection with the rehabilitation of Western United, plus costs of suit and attorneys fees, and all other or further relief allowed by law.

WHEREFORE, Plaintiff prays for a judgment against the Defendant as follows:

1. For damages according to proof to be determined at trial;
2. For interest according to law;
3. For Plaintiff's reasonable attorney's fees incurred herein;
4. For Plaintiff's costs of suit herein; and
5. For such other and further relief as the Court may deem just and proper.

DATED this 14th day of October, 2004.

MERIWETHER D. (MIKE) WILLIAMS
WSBA No. 8255
WINSTON & CASHATT LAWYERS

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